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POLICY NOTES

FINANCIAL POLICIES

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Preface

The outcome document of the 2005 United Nations World Summit called on countries to prepare national development strategies, taking into account the international development goals agreed in the various United Nations Summits and Conferences of the past two decades. In order to assist countries in this task, the United Nations Department of Economic and Social Affairs (DESA) commissioned a series of notes for policy-makers and policy-shapers both in the government and civil society, in major and interconnected areas relevant to the formulation of national development strategies: macroeconomic and growth policies, trade policy, investment and technology policies, financial policies, social policy and state-owned enterprise reform. The preparation of the notes received generous funding in part from the United Nations Development Programme (UNDP). Colleagues from UNDP also provided helpful suggestions for and comments on the notes.

The policy notes, authored by experts in these fields, draw on the experience and dialogues of the United Nations in the economic and social areas, complemented by outside knowledge. The notes provide concrete suggestions on the means to achieve at the national level, the internationally-agreed development goals synthesized in the United Nations Development Agenda. The policy notes are intended to provide those at the country level who shape and set policies, with a range of possible alternatives to the standard policy solutions that have prevailed over the past two decades, rather than to prescribe any single course of action. The notes serve to help countries take advantage of and expand their policy space - their effective room for maneuver in formulating and integrating national economic, social, and environmental policies.

I encourage readers to see these notes as complementary inputs into the debate at the country level on development challenges faced and the policies needed to meet them. The issues chosen are vital pieces of the policy mosaic that underlies national development strategies, which are ultimately geared to achieving sustained economic growth with social inclusion and environmental protection.

José Antonio Ocampo

Under-Secretary-General for Economic and Social Affairs

United Nations

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Table of Contents

Boxes

List of Acronyms

BNDES	Banco Nacional de Desenvolvimento Econômico e Sosial (Brazilian Development Bank)
DAF	Development Assistance Fund (Vietnam)
GDP	Gross Domestic Product
MFI	Micro-Finance Institutions
NGO	Non-Governmental Organization
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
VPSC	Vietnam Postal Service Savings Company

I. INTRODUCTION: OBJECTIVES*

Successful development is not just the growth of productivity and per capita GDP, but also ensuring that the pattern of growth is inclusive, delivers broad-based improvement in the quality of life, and contributes to human development. A National Development Strategy, which includes policies that apply to and take account of the specific features and role of individual sectors, must tailor those policies to achieve the objectives of both growth and human development. This Policy Note discusses the financial policies that can be used to influence, complement and regulate the activities of financial agents to realize these twin objectives.

The financial sector can serve as a significant catalyst to growth by agglomerating the savings of different agents of varying economic strength and allocating it between competing demands for funds. Given the incremental output that can be obtained from a unit of investment, growth in any period depends on the share of national income devoted to investment. Many factors influence the incentives to invest and, therefore, the level and structure of intended investments. However, some or a substantial share of those intentions may remain unrealized, even when potentially viable, because of lack of access to the capital needed to finance such investments or the insurance needed to guard against unforeseen risk. This has obvious implications for growth.

It also affects the realization of human development objectives. Access to financial markets is influenced by the perceptions of creditors, financial investors and insurers regarding the reputation and risk profile of their clients and the adequacy of the collateral they can provide. Hence, it is the poorly endowed and the poor who are most often denied access to these markets, reducing the contribution they make to growth as well as the benefits they derive from it. Thus, the challenge of inclusiveness is substantial in the case of the financial sector, making this a crucial objective to be addressed when seeking to plug gaps in the structure of the sector, guide the behaviour of its actors and influence the outcomes of its operations.

Financial sector operations have differential impacts across groups, regions and individuals, even in times of financial stringency and/or crisis that result from developments within the financial sector itself. As discussed below, features specific to the financial sector and its activities make it prone to fragility and crisis. As and when such fragility arises and results in partial or systemic crisis, its effects are not merely damaging to growth, but also impact on those with limited or no access to the financial sector in the first place and are least able to deal with these effects. Those suffering financial exclusion are not insulated from the effects of financial fragility. Intervention to identify and ameliorate fragility and pre-empt crises is a must.

Finally, since the financial sector includes institutions and agents involved in mediating the flow of foreign capital and savings into the country, their practices have implications for the volume and pattern of foreign capital inflow. If the volume, structure and maturity of such flows are not regulated, they could increase external vulnerability and trigger currency and financial crises, as illustrated by periodic

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episodes of such crises in a number of developing countries. Financial policies must also deal with these potential dangers.

This Policy note identifies policies that can help transform financial agents and markets into instruments of inclusive growth, while ensuring that their presence and/or operations do not render the system fragile and crisis-prone in the long run.

Four broad motives should guide the design of such policies:

1. to ensure availability of finance at costs commensurate with prospective returns to key sectors, projects and agents from a development point of view.
2. to ensure the financial structure does not exclude important sectors of the economy or large sections of the population when such access is required to finance viable productive investment and emergency consumption needs.
3. to minimize the risk that the behaviour of financial agents could result in losses for savers holding financial assets or deposits.
4. to pre-empt financial practices that lead to closure of financial firms and increased fragility of the financial system, and that result in macroeconomic instability.

II. NEED FOR AND CONSTRAINTS ON FINANCIAL INTERVENTION

Policies of intervention are justified because markets often:

a) do not deliver the results needed to advance the objectives of growth and equity, and

b) contribute to widening the distance between actual outcomes and desired goals.

Financial policies are needed because financial markets are not like those for other goods and services. A loan or an insurance contract is not a contemporaneous trade, but a payment made by one party in lieu of an actual or contingent return in the future (Stiglitz 1991).

Information is central to the functioning of financial markets. Savers need information on the viability and practices of financial intermediaries; intermediaries need information on the health and motivations of entities they lend to; and borrowers need information on the options they have when seeking credit.

In practice, information tends to be incomplete and asymmetric in distribution. This has important implications:

- Borrowers are heterogeneous in terms of the probability of default, but banks cannot perfectly judge the probability of default of each borrower. Lending then cannot be determined by the choice of the best project but must involve screening based on incomplete information.
- Incomplete and asymmetric information also makes monitoring difficult. This could, for example, encourage managers to divert profits to managerial perks and investment in management and skills that strengthens their own market position, rather than serve the interests of lenders and equity investors.

- Conventionally, such problems are seen as increasing the possibilities of adverse selection, moral hazard and financial fragility. [1]

Confronted with such problems banks may ration credit and financial investors may hold back credit or equity investment. They may also simultaneously raise interest rates to provide for higher risk, resulting in the exclusion of some borrowers and the inclusion of investors in risky projects that promise high returns.

Financial markets are also prone to failure because of the public goods characteristics of information which agents must acquire and process (Stiglitz, 1993; Rodrik, 1998). Once gathered, information can be used by all simultaneously, and it is difficult to completely prevent others from accessing that information without paying a price. Individual shareholders tend to refrain from investing money and time in acquiring information about managements, hoping that others would do so instead and knowing that all shareholders, including themselves, benefit from the information garnered.

As a result there may be inadequate investment in information and poor monitoring, leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investments, leading to what has been observed as the "herd instinct" characteristic of financial players. This not merely limits access to finance for some agents, but could lead to over-lending to some entities whose failure could have systemic effects. The prevalence of informational externalities aggravates some of these problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Finally, disruptions may occur because expected private returns differ from social returns in many activities. This could result in a situation where the market undertakes unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This activity thrives due to the belief that losses can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can lead to a collapse of the bubble and bank failures.

As a result of all this, financial markets are characterized by features that almost inevitably result in the deviation of actual results from desired outcomes. Some combination of regulation to correct for potential market failure and creation of special institutions is therefore necessary. However, while government intervention is an appropriate response, shaping the nature of that intervention may not be easy. Governments may be the best agents for dealing with problems of incomplete markets and coordination failure, but the problems of screening clients and monitoring

[1] To quote Arestis (2005): "Adverse selection refers to cases when selection is likely to produce adverse results. In the market for loans, for example, the problem refers to borrowers who may not be able to repay their loans; they use the loans for excessively risky investments, but lenders do not know about them due to lack of information. Moral hazard describes a situation where the borrower acts "immorally" – that is, in a way that is not in the best interest of the lenders who possess incomplete information. For example, depositors due to incomplete information cannot observe the high risks banks may undertake, which encourages unscrupulous behaviour."

managers, even if government servants, remain. Moreover, decision-makers as individuals may be driven by private incentives and can use the excuse of pursuing social goals to cover up bad judgment or malpractice. Political favouritism and corruption may take their toll.

For example, many development banks set up to direct credit to specific sectors or target groups have lent money to projects that were neither commercially nor socially profitable or to have inadequately executed their mandate. Even a seemingly successful development bank like BNDES has been faulted for lending mainly to large enterprises. Sometimes such occurrences are the result of bad judgment. But the issue of authority or straightforward corruption, resulting in state organizations becoming the site for private accumulation by redistributing wealth from the government and/or the poor to the rich and/or a powerful elite, has also played a role.

However, given the arguments that warrant intervention in the first instance, a return to the market may not be the best alternative. While choosing the appropriate mix between intervention and the market is necessary, the problems of public governance can in the final analysis be resolved only through the creation of transparent and participative institutional structures, allowing public monitoring of the monitors through parliament and other democratic bodies.

III. DEFINING THE AMBIT OF A FINANCIAL STRATEGY

Given the objectives laid out earlier, the financial policies that need to be formulated are those that:

- determine the contours of the financial structure (in terms of markets, institutions and instruments);
- regulate the activities of financial agents and entities, and
- utilize elements of the structure to realize pre-specified goals.

This definition of the ambit of "financial policy" explicitly excludes those financial interventions that are not sectoral but macroeconomic in nature, and are dealt with in *Macroeconomic and Growth Policies* in this series of Policy notes. For example, the government can be considered the grand financial intermediary in any economy, inasmuch as it absorbs, through taxation, a part of the money incomes and, through borrowing, draws on the savings of the private sector, part of which is transferred to entities needing funds for investment purposes. Through these means the government can seek to ensure the realization in the financial realm of desired rates of savings and a desired allocation of that savings. However, the government is not a financial intermediary, and is normally not an agent seeking to make a profit from the difference between the cost of funds and the returns on subsequent transfers. Hence, the extent to which the government can and should resort to such "intermediation" is not considered the ambit of financial, but fiscal, policy. While there is a need to coordinate fiscal and financial policies, they are conceptually and practically different.

Box 1

Financial Liberalisation and Macroeconomic Policy

Over the last two to three decades, many developing countries, intent on attracting foreign capital flows, have liberalised policies governing the presence and activities of foreign financial firms in their domestic financial sectors. One likely consequence that has received considerable attention is an increase in financial fragility and the likelihood of currency and financial crises. The impact on fiscal and monetary policy has received less attention.

Consider a country that succeeds in attracting large inflows of foreign capital after financial liberalisation. If the economy is unable to immediately absorb these flows, there is an excess supply of foreign exchange in domestic markets that could lead to an appreciation in the value of the domestic currency, which in turn adversely affects export competitiveness.

To deal with this, central banks often purchase dollars (say) and accumulate them as reserves. This increases the demand for foreign exchange and moderates the pressure on the domestic currency to appreciate. However, this also increases the foreign exchange assets of the central bank; its corollary is an increase in its liabilities, implying an increase in money supply. To 'sterilise' the effects of its increased holding of foreign exchange assets, the central bank often chooses to reduce its holding of domestic credit instruments. Since this consists largely of government debt, the net result is a reduction in the holding and accretion of government debt with the central bank.

To accommodate this need to reduce domestic currency assets enforced by the increase in foreign currency assets, three supportive policies are pursued:

i. the fiscal deficit of the government is sought to be pruned, to reduce its overall borrowing requirement;

ii. to the extent that the government chooses to borrow it is forced to increasingly rely on higher cost credit from the "open market" rather than borrowing from the central bank, and

iii. the central bank is sought to be insulated from fiscal developments, by making it autonomous of the government in the sense that it need not respond positively when subjected to additional credit demands from the government.

However, the central bank is not truly "autonomous" since it is forced to purchase autonomous flows of foreign exchange into the country to prevent currency appreciation. As and when it exhausts its available stock of government securities through sterilising sales, it will find that its assets and liabilities, hence the volume of money supply, are influenced by movements of foreign capital. This loss of control over the supply of money implies a loss of monetary sovereignty.

Similarly, the credit-creating behaviour of the banking system as a whole and the interest rate structure it adopts in practice are not treated as strictly "financial sector" concerns, but monetary policy issues. This Policy note restricts consideration of financial policies to those directly affecting the behaviour of financial entities, though such behaviour is circumscribed by central bank's "monetary policy". However, there is no sharp line separating monetary policy from financial policy. This is also true of policies relating to inflows of funds from abroad as recorded in the capital account of the balance of payments in the form of debt, portfolio inflows and foreign direct investment. While these are determined by the capital account policies of the government, some or all of these flows tend to influence the functioning of the financial system and the liquidity available.

The above discussion suggests that the fiscal and monetary policy of the government and its policies with respect to cross-border flows of foreign and domestic capital are prior to and should influence and shape its financial sector policies. This need not be the sequence in practice. Very often, governments begin by making changes in their financial sector policies, which in turn necessitate adjustments in their monetary and fiscal policy stance (See Box 1). Therefore, the discussion here has implications for efforts to establish an appropriate macroeconomic policy framework.

Is more, better?

Often, when designing policies of financial intervention, governments are advised that financial development as measured by the extent of *financial deepening* (the ratio of financial to material wealth) and/or the degree of *financial intermediation* (the share of financial assets of financial institutions in the value of all financial assets) is an unqualified good. This implies that any scheme of intervention that restrains the proliferation of financial markets, institutions and instruments is inappropriate.

However, there is no reason to expect a linear and positive relationship between financial deepening and increased financial intermediation, on the one hand, and growth and equity on the other. Financial deepening and increased financial intermediation have their uses when economies develop and become more complex, but they are not virtues in themselves. In all economies, the value of financial proliferation depends on its ability to ease transactions, facilitate investment and direct financial resources to the projects that yield the best social returns. This implies that there are financial systems and policies that shape these characteristics in ways

Box 2
Unregulated Financial Sectors
Can Be Inappropriate

In practice, there are a number of reasons why autonomously evolved and unregulated financial sectors can be inappropriate from a developmental point of view. For example, informal financial structures in backward and predominantly agrarian economies reflect the unequal distribution of assets and economic power and, because of the inter-linking of land, labour and credit markets, operate in ways that result in usurious moneylending inimical to productive investment. Similarly, autonomously evolved financial structures that reflect a high degree of interconnectedness between an oligopolistic industrial sector and a numerically small set of financial intermediaries are known to result in an excessive concentration of credit and in investment choices influenced by considerations that put at risk the savings of uninformed depositors. According to Diaz-Alejandro (1986:13-14), “between 1975 and 1982, Chile went from a financially shallow economy, where inflation had wiped out the real value of debt, to an excessively financially deep economy where creditors owned a very large share of real wealth, a clear case of 'too much debt and too little equity'.” This was because linkages “between banks and firms, which were hardly arms' length, were responsible for the high use of debt by private firms. In Chile by late 1982 private firms were more indebted than state enterprises; within the private sector, extreme indebtedness was found among those that controlled banks.” By late 1982, the two largest business groups in Chile controlled the principal insurance companies, mutual funds, brokerage houses, the largest private company pension funds and the two largest private commercial banks. Many banks had lent one quarter or more of their resources to affiliates. Such concentration of credit in related enterprises not only results in exclusion of other potential borrowers, but also in lending driven by criteria other than economic or even social returns and in overexposure that can lead to default.

most appropriate for each country at specific stages of development. Autonomously evolved financial systems may not be the most appropriate, since they can reflect the imperfections and inequities of the economic base from which they emerge (Box 2).

This is of relevance since private financial intermediaries are controlled by entities that risk a small volume of their own capital to leverage large volumes of "outside" savings that they are then responsible for allocating. *This makes it imperative that governments act to ensure that resources mobilised by financial intermediaries are put to the best possible use from a social – and not purely private – point of view and that financial systems are relatively safe for investors.*

IV. FINANCE FOR GROWTH THROUGH DEVELOPMENT BANKING

The objective then should be to ensure that the processes of financial expansion occur in the context of a policy regime that can use that expansion as the instrument to realize a wide range of goals such as faster and more broad-based growth and human development. In particular, the delivery of credit to targeted clients, in adequate amounts and at an appropriate interest rate is crucial. This is because in developing countries, especially the poorer amongst them, banking, broadly defined, constitutes the principal segment of the formal financial sector.[2] Further, even though availability of credit in itself cannot be expected to spur investment in a supply-leading manner, wherever the inducement to invest and, therefore, demand for credit, exists, lack of access can prevent the full realization of the potential for investment and growth.

Realizing target credit-deposit ratios

Thus the first objective of policy should be to ensure that credit is available for all bankable projects which have attracted investor interest. A fundamental problem with the inevitable process of financial intermediation by banks and other financial institutions is the mismatch between the maturity (pre-specified period of lock-in) and liquidity (possibility of encashment) characteristics of the liabilities of financial intermediaries and of the loan-demands they face. As a result, financial firms may hold back on credit provision and show a preference for "investment" in gilts, such as government securities, rather than in the provision of credit. This tendency could be aggravated by collateral demands by overcautious lenders which prospective borrowers may not be able to meet. In sum, there could be a process of credit rationing that implies an inadequate degree of aggregate credit provision.

Any growth-oriented financial policy regime must therefore ensure an adequate degree of credit availability. An important instrument in realising that objective is the specification of target credit-deposit ratios that imply an adequate degree of intermediation from a development point of view, to be achieved by the banks. This would also put pressure on banks to reduce their intermediation costs to accommodate lower spreads associated with larger lending. Macroeconomic circumstances, such as recessionary conditions, may on occasion constrain lending by the banks. If this is the case, then low credit-deposit ratios should be treated as a signal for the adoption of policies to revive the economy, since banks cannot be made to bear the burden of circumstances beyond their control.

[2] This segment includes not only commercial banks, but also cooperative credit institutions, specialised development banks aimed at supporting investments in large and medium industry, small scale enterprises and agriculture, specialised refinance institutions and, more recently, microfinance institutions.

Creating long-term credit

Commercial banks, which mobilise finance through savings and time deposits, acquire liabilities that are individually small and protected from income and capital risk, are of short maturity and are substantially liquid in nature. On the other hand, the credit required for most projects tends to be individually large, subject to income and capital risk and substantially illiquid in nature. Consequently, commercial banks conventionally focus on providing working capital credit to industry. This is collateralized by firms' inventories of raw materials, final products and work-in-progress. Though this can involve provision of credit in relatively large volumes, with significant income and credit risk and a degree of illiquidity, it implies a lower degree of maturity and liquidity mismatch than lending for capital investment. This makes banks less suited to lending for capital investment.

As noted elsewhere (United Nations, 2005), left to themselves, private financial markets in developing countries usually fail to provide enough long-term finance to undertake the investments necessary for economic and social development. As a result, firms in developing countries often hold a smaller portion of their total debt in long-term instruments than firms in developed countries. Private institutions may fail to provide such finance because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances, failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned (Stiglitz, 1994).

This creates a shortfall in funds for long-term investments. One way to deal with this problem is to encourage the growth of equity markets. This is attractive because, unlike in the case of debt, risk is shared between the financial investor and the entrepreneur. This enhances the viability of the firm in periods of recession. However, the evidence shows that even in developed countries equity markets play a relatively small role in mobilizing capital for new investments.

To cover the shortfall in funds required for long-term investment, developing countries need to and have created *development banks* with the mandate to provide long-term credit at terms that render such investment sustainable. According to an OECD estimate quoted by Eshag (1983), there were about 340 such banks in some 80 developing countries in the mid-1960s. Over half of these banks were state-owned and funded by the exchequer; the remainder had mixed ownership or were private.

Handicapped by colonial legacies, international inequalities and various systemic biases, these kinds of institutions are a 'must' for developing countries. Any national strategy of modernisation in a mixed-economy framework must provide for the establishment of institutions of this kind. However, it is best to create separate development banks to provide long-term capital at near-commercial rates and "policy banks" to provide credit to special areas such as agriculture or the small scale sector where interest rates have to be subsidized and grace periods have to be longer. This allows different criteria to be applied to the evaluation of the performance of these banks, with profitability a more important consideration in the case of the former.

Since development banks play a role normally bypassed by commercial banks and as they are funded by the state (with deep pockets), there is always the possibility that lending to projects that are neither commercially viable nor socially profitable may occur for reasons other than errors of judgment. Governance mechanisms to ensure transparent procedures, adequate disclosure and participative monitoring involving oversight by democratically elected bodies are crucial. Such mechanisms should not be diluted or passed up on the grounds that they undermine managerial autonomy.

Ensuring sectoral distribution

Growth requires not just an adequate volume of credit but an appropriate distribution of such credit. For example, certain sectors – infrastructure being the most obvious – are characterised by significant "economy-wide externalities". That is, their presence is a prerequisite for and a facilitator of growth in other sectors. But the infrastructure sector is usually characterised by lumpy investments, long gestation lags, higher risk and lower profit. Banks would be wary of lending to such projects, given the maturity and liquidity mismatch involved. Such reticence would be greater in economies with a predominantly private banking system. If private – rather than social – returns drive the allocation of financial savings, these sectors would receive inadequate capital, even though their capital-intensive nature demands that a disproportionate share be diverted to them. Given the "economy-wide externalities" associated with such sectors, inadequate investments in infrastructure obviously constrain the rate of growth. Hence, specialised policy development banks are needed, with sources of finance other than deposits by small savers (Box 3). While such institutions can be

Box 3
Development Finance in Vietnam

In Vietnam, the government has continued with targeted lending for specific purposes even after the adoption of financial liberalization policies. This involved the creation of a special Development Assistance Fund (DAF) in 200, separate from the commercial banking system, which had as its objectives: (i) the provision of subsidized state loans for medium to long-term investments in priority sectors such as infrastructure, heavy industry and public services, (ii) provision of interest-rate support and investment guarantees for chosen projects, and (iii) provision of short-term export promotion credit. Support in these forms can go to both private and state-owned enterprises, taking account of both commercial and policy criteria, such as encouraging investment in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces, with a registered capital of five billion dong (US$326.8 million). Before 2002, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company (VPSC),3 the government budget, loan repayments, and official development assistance (ODA). Since 2002, the DAF has been expected to mobilize its own resources. It continues to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

Outstanding credit from the DAF in 2001 to 2002, and loan disbursements in 2002 and 2003 grew much faster than total domestic credit to the economy. As a result disbursements through the DAF amounted to an increasing share of domestic credit, reaching 24 percent in 2002, equal to 3.3 per cent of GDP. Over time, the DAF has emerged as the largest financial intermediary in Vietnam for channelling domestic and foreign funds to investment activities (Weeks et al., 2003).

[3] VPSC was established in 1999. In 2002, it already had 539 to 600 branches all over the country, and has been a good and fast-growing venue to mobilize rural savings. There are around half a million deposit accounts with outstanding deposits at D3.8 billion (around US$250 million).

funded by the government or the central bank, government guarantees on borrowing by these entities is needed if adequate capital is to be mobilized.

Development banks of this kind can help address the fact that local industrialists may not have adequate capital to invest in capacity of the requisite scale in more capital-intensive industries characterised by significant economies of scale. They help promote such ventures through their lending and investment practices, and often provide technical assistance to their clients. Given the inadequate development of equity and long-term debt markets in developing countries, these institutions soon account for an important share of external finance for the private sector.

Leveraging capital provision to influence investment decision and performance

The need for a growth-oriented financial policy to extend credit to special sectors such as infrastructure is an important component of a larger requirement in economies with predominantly private investment decision makers: the need to ensure that the pattern of production is geared to maximising growth. In economies with an important role for private agents in investment decision-making, market signals determine the allocation of resources for investment and, therefore, the demand for and allocation of savings intermediated by financial enterprises. This can result in "short-termism" of various kinds, resulting in inadequate investment in sectors with significant "external" effects and long-term potential from the point of view of growth. In addition, the private-profit driven allocation of savings and investment could direct investment to capital- and import-intensive sectors, adversely affecting the balance of payments and the employment elasticity of output growth in the process. This could constrain the pace of growth, as well as the pursuit and efficacy of the poverty reduction effort.

Realizing a growth-oriented pattern of production of goods and services requires the state to guide the allocation of investment. Since independent and atomistic decision makers cannot have the economy-wide and "social" seeing power to undertake such coordination and targeting, the state must play a role in overcoming market failure resulting from inadequate coordination. One way to do this is to use the financial sector as an instrument for investment coordination and targeting. Even in developing countries that choose outward-oriented strategies or are forced to choose a more mercantilist strategy of growth based on rapid acquisition of larger shares in segments of the world market for manufactures, the relevant segments have to be identified by an agency other than individual firms. Experience indicates that the state has the capacity to assess and match global opportunities and economy-wide capabilities.

Hence, though its financial policies, the state must ensure an adequate flow of credit at favourable interest rates to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they expand market share. The state must not merely play the role of investment coordinator; it needs to use the financial system to direct investment to sectors and technologies at appropriate scales of production. Equity investments and directed credit are important instruments in such a state-led or state-influenced development trajectory.

Executing this role requires leveraging lending to influence investment decisions and monitor the performance of borrowers. Financial institutions in backward countries have to undertake entrepreneurial functions, such as determining the scale of investment, the choice of technology and the markets to be targeted by industry, and extension functions, such as offering technical support to the farming community. Stated otherwise, financial policies may not help directly to increase the rate of savings and ensure that the available *ex ante* savings are invested, but they can be used to influence the financial structure so as to ensure that lending leads to productive investment that accelerates growth and makes such lending sustainable.

Development and commercial banks can also monitor corporate governance and performance on behalf of all stakeholders, rather than rely on the system of indirect monitoring resulting from the discipline exerted by the threat of takeover in stock markets ostensibly prevalent in the United States and the United Kingdom. The effectiveness of the latter option is limited. Moreover, it is not available in most developing countries where equity markets are poorly developed and most firms are not listed.

In practice, development banks do not always leverage their capital-provision role to intervene effectively in management in all contexts. In some countries, despite a significant role as providers of finance, development banks adopt a passive role with respect to technological or managerial decisions of private borrowers, avoiding a role that such institutions are expected to play. This is also the loss of an opportunity, not only to exploit the economies of scale associated with investment in knowledge skills of certain kinds, but also to coordinate investment decisions in systems dominated by private decision-making.

Role for differential interest rates

Since one of the objectives of these actions is to guide investment to chosen sectors, the rate of interest on loans to favoured sectors may have to be lower than even the prime lending rate offered to the best borrowers, judged by credit-worthiness. That is, differentials in interest rates supported with subsidies or enabled by cross-subsidization is part of a directed lending regime.

Financial policies were an important component of the strategic policies pursued by countries like the Republic of Korea and Taiwan Province of China on the way to competitive success (Wade, 1991; Amsden, 1989). These included interest rate differentials and bank financing of private investment, resulting from the channelling of corporate finance through a still largely regulated banking system.

Table 1 summarises some of the main financial policy options that can be used to accelerate growth.

Table 1
Some Salient Financial Policy Options to Promote Growth

Policy	Objective	Dangers	Requirements
Target credit-deposit ratios	Ensuring banks create adequate credit from deposits they garner, rather than invest in secure instruments such as government securities or in commercial paper and rationing credit	a. Indiscriminate lending to meet targets resulting in adverse selection b. Low spreads adversely affecting profitability	a. Clear guidelines on screening of clients b. Emphasis on social return rather than profitability in performance assessments c. Flexibility to determine interest rates to permit cross-subsidization d. Refinance on concessionary terms for lending to specific target groups
Create and/or strengthen development banks	Fill the shortfall in funds available for long-term investment from banks	Lending to projects that are neither commercially viable nor socially profitable	a. Adoption of alternative performance criteria b. Implementation of transparent procedures and participative governance mechanisms
Separate development banks from "policy banks"	a. Allows defining the objectives of the institution clearly, such as providing long-term credit as opposed to directed credit at concessional terms b. Allows for implementation of different performance criteria	The opportunity to cross-subsidize different segments may be passed up.	Systems to evaluate the appropriate degree of concessionality and volume of subsidy for policy banks in different areas

Table 1 (cont.)
Some Salient Financial Policy Options to Promote Growth

Policy	Objective	Dangers	Requirements
Directed lending for sectors characterized by externalities, especially "economy-wide" externalities	Ensuring growth	Same as for policy banks	a. Provision of government guarantees for borrowing by these entities b. Creating specialized development banks/vehicles for the purpose
Leverage capital provision to influence investment decisions and monitor performance	a. Overcome "coordination failures" and "short-termism" b. Ensure investments incorporate best-practice techniques, of appropriate scale c. Influence pricing and marketing policies, especially for global markets d. Monitor corporate governance and performance	a. Possibility of "government failure" leading to wrong decisions b. Possibility of wrong decisions influenced by conflicts of interest, corruption, etc.	Implementation of transparent procedures and participatory governance mechanisms
Differential or discriminatory interest rates	Realize the objectives of directed credit and render the programme viable	Same as above	a. Possibility of cross-subsidization b. Provision of interest subsidies c. Implementation of transparent procedures and participative governance mechanisms

V. FINANCIAL POLICIES TO PROMOTE EQUITY AND HUMAN DEVELOPMENT

When countries frame policies that determine their financial structures and influence the behaviour of domestic financial agents, the concern is not just with accelerating growth. As important is the need to ensure that such development is broad-based. An obvious prerequisite for this is that the coverage of lending, supervisory and developmental services of the financial sector must be near comprehensive. The creation of an inclusive financial sector, defined as one that provides "access to credit for all "bankable" people and firms, to insurance for all insurable people and firms and to savings and payments services for everyone" (United Nations 2006:1), should be among the prime objectives of financial policy.

In practice, there is only limited access to the financial sector in many developing countries. According to recent estimates (United Nations, 2006), an average of 89.6 per cent of the population in the 15 countries of the European Union have a bank or postal savings account. The comparable figure for the United States is 91.0 per cent. In contrast, in a set of ten developing countries or major cities in such countries, the figure varied from as low as 6.4 per cent to a maximum of 47 per cent (**Table 2**). This is a matter of concern since, "access to a well-functioning financial system can economically and socially empower individuals, in particular poor people, allowing them to better integrate into the economy of their countries, actively contribute to their development and protect themselves against economic shocks (United Nations, 2006:4). As the *World Economic and Social Survey 2005* (United Nations, 2005:26) noted: "This lack of access to finance has become a matter of wider development-related concern because deeper and more inclusive financial systems are linked to economic development and poverty alleviation."

Table 2
Populations with a Savings Account in Selected Developing Countries/Locations

Botswana	47 0
Brazil (urban)	43 0
Colombia (Bogotá)	39 0
Djibouti	24 8
Lesotho	17 0
Mexico City	21 3
Namibia	28 4
South Africa	31 7
Swaziland	35 3
Tanzania	6 4

Source: United Nations, 2006:2

Access to credit for women is worse than for men. Studies have shown that women entrepreneurs often face problems of gender bias, which can severely hamper women seeking small business credit. This happens despite evidence that women generally have a higher loan repayment rate than men. Women also tend to lack the collateral needed for loans, often due to social and legal disadvantages such as lower wage incomes or limitations on property ownership (UNCTAD, 2001:38).

Inadequate region-, class- and unit-wise allocation is often the outcome of allocation driven purely by considerations of private profit rather than social returns. Credit allocation driven by private returns can aggravate the inherent tendency in markets to concentrate investible funds in the hands of a few large players in sectors delivering high private profits and to direct savings to already well-developed centres of economic activity. Besides resulting in excess exposure to certain sectors and segments, this concentration of financial flows militates against broad-based development (Box 2). Consequently, financial policies are often designed to ensure adequate flows of capital to less developed areas of the economy and to disadvantaged sections of the population.

Thus, financial exclusion is not just a matter of inadequate access for individuals, but for whole sectors such as agriculture or small-scale industry. As a result of such exclusion, financial flows can be mechanisms that significantly aggravate the biased developmental outcomes of the unequal distribution of assets. This occurs because the divergence between private returns and social returns varies across sectors, and private returns tend to be higher in sectors (say, real estate and the stock market) where social returns are low. It also occurs because financial intermediaries concentrate in their hands household savings, which tend to be a relatively high share of total savings in the system. If the allocation of these savings is governed by the private predilections of those who control or manage these intermediaries, the bias in allocations can be substantial and not necessarily always socially efficient.

Further, in poor countries, where the pattern of effective demand is significantly influenced by the extent of inequality, market signals could direct credit to capital- and import-intensive sectors, the expansion of which may have limited effects on employment, incomes and poverty reduction.

Box 4
Financial Exclusion in India pre -Nationalization

Features of financial exclusion were visible in India before the nationalization of major banks in 1969 and the promotion of a policy of social reorientation.

First, the coverage of the branch network was unduly low compared with the size of the population – an average of one branch office for 65,000 persons, whereas the developed-country norm was one branch per 8,000 population.

Second, the urban orientation of the banking system was obvious. At the end of June 1969, there were just 1,832 (or 22.2. per cent) out of 8,262 bank branches located in rural areas. This spread was only achieved because of the accelerated branch banking policy of the State Bank of India, which operated 629 branches in rural areas.

Third, concentration was excessive even in urban areas. As of April 1969, there were 617 towns without any commercial bank branch; of these, 444 were not served by any bank at all. Five metropolitan cities (Bombay, Calcutta, Delhi, Madras and Ahmedabad) accounted for 46 per cent of total bank deposits and 65 per cent of total bank credit as at the end of 1967.

Fourth, the most disconcerting aspect of the banking structure was the sectoral distribution of bank credit. The share of agriculture in total bank advances in 1951 was 2.1 per cent; it had declined to 0.2 per cent by 1965-66. On the other hand, the share of industry in bank credit increased from 30.4 per cent in 1949 to 52.7 per cent in 1961 and further to 62.7 per cent in March 1966.

Finally, the financial stake of the shareholders in banks was almost negligible. For major banks, paid-up capital constituted just about 1 per cent of total bank deposits (ICBP, 2006).

As a result of such tendencies, a number of weaknesses afflict the banking system in developing countries, including those with relatively more developed financial systems, such as India (Box 4). They include:

- poor population coverage as measured by the ratio of bank branches, deposits and credit to the population;
- urban concentration;

- significant inequities in the sectoral allocation of credit, and
- excessive control over banks by industrial and commercial interests.

Ensuring financial inclusion

It is because of these outcomes associated with the operation of "self-organized" financial systems, that financial policies aimed at ensuring financial inclusion must be an important component of a national development strategy. In developing countries adopting a mixed economy framework with significant private initiative and investment, the financial sector has to play a major role in a system of "inclusive finance" by channelling credit at reasonable interest rates to units and agents, so as to ensure a degree of inter-sectoral, rural-urban, region-wise and asset size-wise balance in credit disbursal. In particular, it is necessary to ensure that financial flows reach sectors and sections that would otherwise be bypassed or neglected.

Bank branching

A basic requirement for such financial inclusion is widely accessible deposit and credit facilities, through banks, post offices and other institutions. While the post office can play a partial role, increasing the number and spread of bank branches is crucial. Most developing countries are underserved in terms of the number of bank branches per thousand of the population. Governments should adopt a scheme of branch licensing to ensure branching in underserved areas or specify a ratio of branching in well-served and underserved areas, or of urban to rural branches, for example, that must be maintained.

Preventing credit migration

Bank branching in underserved areas, while helpful in from mobilising deposits in institutions belonging to the formal financial sector, is no guarantee of balanced regional credit dispersion. Deposits mobilised in rural areas or backward regions can be used by geographically diversified banks to provide credit to clients in urban areas or more developed regions. More extensive bank branching must be accompanied with guidelines to prevent excessive credit migration from less to more developed areas in the country (Box 5).

Box 5
Preventing Credit Migration

The United States passed the Community Reinvestment Act in 1977, which requires banks to provide credit to neighbourhoods in which they raise funds from deposits. This is enforced through the collection of data that banks are required to file, by postal zone, on the source of their deposits and the destination of their loans, leases and other lines of credit. Other banking laws prohibit banks from denying credit on the basis of race, ethnicity, and gender. This explicit prohibition against discrimination, enforceable by bank regulators and by private lawsuits to recover damages, helps promote lending to those members of society. These banking laws promote the policy of inclusive finance, and they are supported on the grounds that discrimination is wrong and that banks should not drain savings from any area but instead be responsible for mobilizing savings into credit for investment and consumption.

Preventing credit concentration

Given the incompleteness of information available to lenders, the adage that "nothing succeeds like success" would tend to hold. Agents with a longstanding relationship with a bank, a good track record and significant financial strength, may be favoured with a disproportionate share of credit. This could lead to large individual loan contracts for such clients and to the accommodation of multiple applications from the same client. A concomitant would be the exclusion of other bankable and needy projects. While large, creditworthy borrowers should not be overly discriminated against, measures are needed to prevent their past success being a barrier to access for others. A simple way to deal with this likelihood is to institute a "credit authorization scheme", requiring banks to obtain prior authorisation from a designated body to grant credit above a particular level to any single party so as to align credit policy more closely with developmental objectives. The other is to set strict limits on credit provided to interlinked firms controlled by a single authority, which also helps reduce risk due to failures of a single set of agents.

Directed credit

Central to a framework of inclusive finance are policies aimed at pre-empting bank credit for selected sectors like agriculture and small-scale industry. Pre-emption can take the form of specifying that a certain proportion of lending should be directed at these sectors. In addition, through mechanisms such as the provision of refinance facilities, banks can be offered incentives to realise their targets. Directed credit programmes should also be accompanied by a regime of differential interest rates that ensure demand for credit from targeted sectors by cheapening the cost of credit. Such policies have been and are still used in developed countries as well (Box 6).

Box 6
FarmerMac:
Farm Credit System in the United States

A lesson for developing countries from developed country experience can be found in U.S. financial policy for assuring adequate credit flows to its agricultural sector. The Federal Farm Loan Act of 1916 established a nationwide Farm Credit System – a network of credit cooperatives – that have proven to be a reliable source of funding for farmers, ranchers and aquatic producers during good times as well as bad. This includes 12 regional farm land banks whose original capital was supplied mostly by the government. Two related government-owned funding corporations raised money from capital markets by issuing bonds. These funds are lent to the network of credit banks and credit cooperatives at interest rates that reflect the government's low cost of borrowing. In turn these funds are lent to rural producers and home-owners. It has proven to be low cost, stable and non-cyclical.

Credit pre-emption, aimed at directing debt-financed expenditures to specific sectors, can also be directly exploited by the state. In many instances, besides a cash reserve ratio, the central bank requires a part of the deposits of the banking system to be held in specified securities, including government securities. This ensures that banks are forced to make a definite volume of investment in debt issued by government agencies. Such debt can be used to finance expenditures warranted by the overall development strategy of the government, including its poverty alleviation component. Beyond a point, however, these roles have to be dissociated from traditional commercial banks and located in specialized institutions.

Institutional safeguards

The need to ensure inclusion may be accepted by line officials, managers and directors, but the motivation to realise these objectives may not exist, resulting in slippages. Institutional mechanisms to ensure cognition and pursuit of this objective when making lending decisions are crucial. One form such a mechanism can take is a statutory requirement to constitute commercial bank boards with representation for different stakeholders, including sectors normally neglected in credit provision, so as to monitor and ensure financial inclusion.

Supply-leading role

Finally, it is not enough for institutional mandates to ensure "financial inclusion", to merely accept it as an objective, and wait for credible borrowers to arrive. Small, inexperienced and poor borrowers may neither be familiar with the borrowing options they have nor have the capacity to design and frame a project in ways that can render it successful and creditworthy. Inclusive banking, therefore, requires institutions that take on a supply-leading role, identifying potential entrepreneurs with bankable projects, helping them through the phases of project preparation and credit appraisal, and ensuring successful and timely implementation. The relationship should not end there either. Rather, the lending institution should use the leverage provided by its support to monitor the functioning of small and medium scale businesses to render them productive and financially sustainable.

A case for public ownership

Inclusive finance of this kind inevitably involves the spread of formal financial systems to areas where client densities are low and transaction costs are high. Further, to ensure sustainable credit up-take by disadvantaged groups, interest rates charged may have to diverge from market rates. This regime of differential or discriminatory interest rates may require policies of cross-subsidization and even government support to ensure the viability of chosen financial intermediaries. Intervention of this kind presumes a substantial degree of "social control" over commercial banks and development banking institutions.

It implies that "social banking" involves a departure from conventional indicators of financial performance such as costs and profitability and requires the creation of regulatory systems that ensure that the "special status" of these institutions is not misused. In sum, "inclusive finance" is a regime is defined as much by the financial structure in place as by policies such as directed credit and differential interest rates. In particular, it involves a substantial measure of social regulation of banking.

If instruments of social control of the kind discussed above prove inadequate to ensure compliance with financial inclusion guidelines, governments can use and have used public ownership of a significant section of the banking/financial system to ensure the realization of developmental and distributional objectives. If an overwhelmingly dominant banking system has to play a role in directing savings and rendering the financial structure inclusive, the question of ownership and/or regulatory structure of the banking industry has to be addressed.

This was recognized by governments in many countries in Europe, where banking development in the early post-World War II period took account of the vital differences between banking and other industries. Recognizing the role the banking industry could play, many countries with predominantly capitalist economic structures thought it fit either to nationalize their banks or to subject them to rigorous surveillance and social control. France, Italy and Sweden are typical examples in this respect. Overall, even as late as the 1970s, the state owned as much as 40 per cent of the assets of the largest commercial and development banks in the industrialized countries (United Nations, 2005). An example of a more recent successful transition to inclusive finance through nationalization of a significant part of the banking system is India post-1969 (Box 7).

Box 7
Public Ownership and Inclusive Finance in India

India's achievements with regard to financial sector development after bank nationalisation have been remarkable. There was a substantial increase in the geographical spread and functional reach of banking, with nearly 62,000 bank branches in the country as of March 1991, of which over 35,000 (or over 58 per cent) were in rural areas. Along with this expansion of the bank branch network, steady increases were recorded in the share of rural areas in aggregate deposits and credit. From 6.3 per cent in December 1969, the share of rural deposits in the total rose to touch 15.5 per cent by March 1991 and the rural share of credit rose from 3.3 per cent to 15.0 per cent. More significantly, with the target credit-deposit (C-D) ratio set at 60 per cent, the C-D ratios of rural branches touched 64-65 per cent on the basis of sanctions. Sectorally, a major achievement of the banking industry in the 1970s and 1980s was a decisive shift in credit deployment in favour of the agricultural sector. From an extremely low level at the time of bank nationalization, the credit share of the sector grew to nearly 11 per cent in the mid-1970s and to a peak of about 18 per cent (the official target) at the end of the 1980s (ICBP 2006).

The declared objectives of public presence in and social regulation over banking are:

- to ensure a wider territorial and regional spread of the branch network;
- to ensure better mobilization of financial savings by the formal sector through bank deposits; and
- to reorient credit deployment in favour of hitherto neglected or disadvantaged sections by reducing control by a few private entities.

Public ownership of banks also serves a number of overarching objectives:

- It ensures the information flow and access needed to pre-empt fragility by substantially reducing any incompatibility in incentives driving bank managers, on the one hand, and bank supervisors and regulators, on the other.
- By subordinating the profit motive to social objectives, it allows the system to exploit the potential for cross subsidization and to direct credit, despite higher costs, to targeted sectors and disadvantaged sections of society at different interest rates. This permits the fashioning of a system of inclusive finance that can substantially reduce financial exclusion.
- By giving the state influence over the process of financial intermediation, it allows the government to use the banking industry as a lever to advance the development effort. In particular, it allows for the mobilization of technical

and scientific talent to deliver both credit and technical support to agriculture and the small-scale industrial sector.

This multifaceted role for state-controlled banking allows credit to lead economic activity in chosen sectors, regions and segments of the population. It amounts to building a financial structure in anticipation of real sector activities, particularly in underdeveloped and under-banked regions of a country.

Financial innovation for development

Policy banking

Financial inclusion requires not just social control over commercial banks, but the creation of special institutions such as "policy-oriented" development banks, cooperative credit organizations and specialized rural financial agencies. It may also require prescribing specific quantitative targets for managers of these institutions.

Fundamentally, policy banking is required because, as noted above, private lenders are only concerned with the returns they receive. On the other hand, the total return to a project includes the additional surplus (or profit) accruing to the entrepreneur, and the non-pecuniary social returns accruing to society. The projects that offer the best return to the lender may not be those with the highest total expected return. As a result, good projects get rationed out, necessitating measures such as development banking or directed credit (Stiglitz 1994).

In practice, financial intermediaries seek to match the demand for credit by adjusting not just interest rates, but also the terms on which credit is provided. Lending gets linked to collateral, and the nature and quality of that collateral is adjusted according to the nature of the borrower as well as supply and demand conditions in the credit market. Depending on the quantum and cost of funds available to the financial intermediaries, the market tends to ration out borrowers to differing extent. In such circumstances, borrowers rationed out because they are considered risky may not be the ones that are the least important from a social point of view.

Policy banks are expected to focus on specific sectors such as the small-scale industrial sector, providing them with long-term finance and working capital at subsidised interest rates with longer grace periods, as well as offering training and technical assistance in areas like marketing. Similarly, agricultural development banks, most of which are state-backed and funded, advance credit at subsidised rates to the agricultural sector, in particular to small and marginal farmers without the means to undertake much-needed investments. Given their low credit rating, these farmers are excluded from the normal lending of commercial banks and are forced to rely on "informal" sources, such as professional moneylenders, landlords and traders, at interest rates far exceeding those charged by commercial banks.

These institutions must not be seen as a drain on the exchequer, except when they do not function according to accepted norms. Directed credit has positive fiscal consequences. In contrast to subsidies, such credit reduces the demand on the government's own revenues. This makes directed credit an advantageous option in developing countries faced with chronic budgetary difficulties that limit their ability to use budgetary subsidies to achieve a certain allocation of investible resources.

To deal with these problems, countries must incorporate the following in their national development strategies:

i. Create and/or strengthen policy banks to provide credit to specified clients (often in targeted quantities) at interest rates which they can reasonably pay given their expected returns;
ii. Make it incumbent on policy banks to intervene in the functioning of the entities to which they lend, with nominee directors on the board, backed by technical and managerial expertise in the development bank's offices;
iii. Allow for the possibility that policy banks can encourage commercial banks, normally concerned with short term lending for working capital purposes, to undertake long-term lending as well. They can do this by offering guarantees as well as refinance facilities at reasonable rates against long-term loans provided by commercial banks for specific purposes. By reducing default and liquidity risks for the commercial banks, such facilities enable them to play a role in the market for long-term funds;
iv. Provide policy banks with forms of financial support – such as long-term funds from the central banks (financed out of their "profits"), long-term loans or equity contributions from the government, loans from multilateral and bilateral agencies guaranteed by the government, and concessions such as the grant of tax-free status – to ensure the viability of these institutions and the efficacy of their operations. This is necessary because, given the role that development banks are expected to play, it is difficult for them to compete with commercial banks and other financial intermediaries to mobilise funds from the market. The cost and short-term maturities of such liabilities make it difficult to realise the objectives for which these institutions are established in the first instance;
v. Ensure that development banks leverage their lending to monitor their clients and direct them to adopt technologies, marketing and managerial practices that would render them viable.

Cooperatives

Another channel to deliver credit as part of a system of inclusive finance is cooperative banks incorporating of members from the target community, set up with state aid and supported by state subsidy. Cooperatives have a long history and have been extremely successful in many contexts. They have also played an important role in developed country contexts, as illustrated by the credit union movement in the United States (Box 8).

> **Box 8**
> **Credit Unions in the United States**
>
> Credit unions played an important role in development in the United States. Credit unions are member-owned organizations that offer higher interest rates on savings and charge lower interest rates on loans compared with commercial banks. The credit unions return any profit to their members at the end of each year, and they operate as non-profits, paying no taxes on earnings that are retained or paid out to members. This tax-exempt status helped the expansion and growth of credit unions, despite the competition from commercial banks.

Cooperative banks were promoted, based partly on the view that the systems and procedures of traditional banks were determined by the needs of urban industrial and business financing, making them inadequate agencies for covering the last mile in rural areas. Their methods are not always appropriate for banking with the poor, which involves intensive relationship banking that permits the use of social collateral. Dependent largely on documentation-based appraisal, they are inadequate in environments where lending needs to be based more on trust and production related appraisals. This makes cooperative banks, constituted with target group members, much better vehicles for delivering credit to small and marginal farmers, and those who have little or no productive assets. A cooperative bank component to a system of inclusive finance is, therefore, imperative.

However, while formally cooperatives are democratic institutions with participatory management and peer-group monitoring, in practice local class hierarchies and patronage structures result in their managements being dominated by powerful rural interest groups. Since their constitution and structure makes them less accountable to oversight agencies in the formal banking sector, there can be significant failures of governance. This substantially influences their lending decisions, leading even to diversion of credit away from the region. In India, for example, cooperative banks are known to have financed dubious investments in metropolitan stock markets leading to substantial losses.

Moreover, since these institutions are convenient vehicles for governments to channel their development budgets and subsidies, they become the conduit for leakages of expenditures targeted at disadvantaged groups. They also serve as conduits to distribute political patronage, often resulting in politicians dominating the boards of cooperative banks.

Such problems do not warrant dispensing with cooperatives and the role they can play. Governments must enact laws aimed at ensuring the participatory nature of managements of cooperative banks and preventing conflicts of interest from marring the managements and their practices. They should also create special regulatory institutions to monitor these institutions to ensure proper use of funds and the sustainability of their finances.

Micro-finance institutions (MFIs)

Conventional development banks and cooperatives may not be adequate as a source of finance for the poorest. Hence, an often-advocated strategy for ensuring inclusion is the promotion of micro-credit through micro-finance institutions. Micro-finance has been defined as the provision of diverse financial services (credit, savings, insurance, remittances, money transfers, leasing) to poor and low-income people. The case for micro-finance is based on the understanding that:

- even if a policy of inclusive banking is adopted, the likelihood that the really poor will be touched by the formal banking system, including cooperatives, is low;
- thus, the poorest will be deprived of credit or be dependent on informal sources at interest rates that limits their resort to credit to emergencies;
- access to individual and household level micro-credit may be crucial to ensuring earning opportunities for the majority, since wage employment in agriculture and small businesses cannot meet the scale of demand for livelihood opportunities, especially in the rural areas, and
- they permit the creation of self-help groups, often constituted by women, and can be a potent means for social mobilization and women's empowerment.

Box 9
The Spread of Microfinance

At the end of 2004, there were 3,044 MFIs in developing countries making microloans to over 92 million clients. Of these, 66.5 million were classified as among the "poorest" people, 55.6 million of them women. Though concentrated in Asia, which accounts for 88 per cent of all reported loan clients in developing countries, significant numbers of MFIs operate elsewhere: 994 in Africa, 388 in Latin America and the Caribbean and 34 in the Middle East. While MFIs may lend very small amounts, they can be very large organizations. Eight individual institutions and three networks each served one million or more clients. Adding the 41 individual institutions that served between 100,000 and a million clients would account for almost 84 per cent of all poor clients served. The rest were serviced by the remaining 3,000 MFIs, the overwhelming majority serving fewer than 2,500 clients each.

Extracted from: United Nations, 2006:13-15.

Thus, micro-finance should be promoted as a complement to formal finance and a substitute for informal sources of credit in urban and rural areas. However, it is necessary to address problems confronted by the micro-finance movement across the developing world.

There has been an explosion of micro-credit programmes since the 1990s, implemented under various institutional arrangements, run by NGOs as well as, increasingly, government organizations, often supported by bilateral and multilateral donor assistance and advice (Box 9). Many of these experiments have been successful in displacing exploitative, informal private sector creditors, meeting demands for credit to finance consumption and emergency expenditures and, in some cases, even small investments.

There is much praise of the pro-poor consequences of many of these programmes. These are targeted at specific sectors with a preponderance of the poor, provide credit without collateral on the basis of peer group guarantees, and on occasion, combine credit with other technical services. In Bangladesh, for example, micro-credit has been seen as the favoured alternative means of credit delivery to the poor. That country was a leader in attempting to use micro-credit as a solution to the credit access problem for the poor created by financial liberalisation, with the Grameen Bank becoming a model for similar experiments elsewhere in the developing world. The average annual disbursement of loans from these programmes is estimated to be over Taka 5000 crores (US$0.9 billion), far exceeding the total rural operations of the nationalised banks and specialised banking institutions taken together. Impressed by the growth of the movement, the government has even attempted to centralise flows of micro-credit through a public sector organisation created for the purpose, the *Palli Karma Sahayak Foundation* (PKSF) (Osmani *et al.*, 2003).

With hindsight, it is clear that, despite successes, there are a number of problems that plague micro-finance in developing countries. Besides differences in the actual extent of coverage of the rural poor and contribution to poverty alleviation, some common problems are:

- excessively high rates of interest, making successful lending for productive investment near impossible;
- inability to reach, in a financially viable way, the really poor;[4]

[4] In addition, as United Nations (2006:37) notes: "As crucial as the microcredit revolution has been, it has not provided the full range of credit products needed by poor people. The one-size-fits-all working

- donor dependence, and
- financial non-sustainability.

Part of the reason for the high interest rates is the extremely high transaction costs associated with micro-finance ventures. As is widely recognised (United Nations, 2006), the cost of disbursing, managing and collecting instalment payments on many tiny loans, often at frequent intervals, is significantly more costly than for fewer loans of larger amounts. In addition, reaching poor clients requires more staff time and personal interaction, implying additional costs. Staff time is increased because of illiteracy, the need to explain borrower and lender responsibilities and obligations, and the travel distances over poor infrastructure. Further, banking for the poor is a high-risk activity, given the vulnerability and high failure rates of units/activities set up by such borrowers.

Promotion of micro-finance, despite these higher transaction costs, is warranted because MFIs can provide the close supervision and support to borrowers that mainstream financial institutions cannot afford. They serve as micro-development banks, offering extension services to the poor, and as an effective instrument to bring the illiterate rural poor into the cash economy and to impart some managerial and financial discipline to them. It is the lack of such discipline which perpetuates the view that lending to the poor is a mere "handout", based on instances of failure or lack of sustainability of traditional state- or donor-financed rural credit schemes operated through banks.

However, it would be utopian to believe that this role of MFIs can be extended to a level where they provide credit for all viable projects on a self-financing basis. The higher transaction costs have to be covered by some combination of higher-than-market interest rates and interest subsidies. The larger the subsidy and lower the interest, the higher the possibility that micro-credit can be used for financing projects involving fixed-investment. But, since micro-credit is also used for non-productive purposes, the presence or extent of the subsidy should be calibrated according to the purpose for which credit is sought. Peer-group monitoring can help with such calibration. This will also serve to discourage excess borrowing for non-productive uses. To exploit these potential features of micro-finance for social benefit, the state and the donor community should consider supporting it with subsidies. If no subsidies and transfers from the state or other donors are available to render micro-financial services a feasible source of capital for productive investment, successfully scaling up of donor-driven experiments will prove difficult.

Micro-finance has to be viewed as a form of small-scale development banking – requiring heavy effective subsidies even while charging relatively high interest rates – rather than as having any connection with commercial banking. Backed by some donors, commercial banking institutions, seeing MFIs as a potential source of competition, have sought to dilute this role of micro-finance as a complementary, separate channel of provision of finance with its own requirements. They have promoted the view that MFIs should, over a period of time, graduate into more

capital loan entails inflexible terms, rigid loan cycles and amounts that are only suitable for microbusinesses with high turnover or those that produce regular weekly or monthly cash flows. The inflexibility of the product limits its usefulness to people who operate businesses with irregular cash flows, or require higher (or lower) amounts to support their businesses. Customers may use the inappropriate credit product, may not qualify for it, or may simply decide not to borrow."

diversified non-bank financial companies or serve as delivery mechanisms for the formal financial system in a new form of "agency banking". Thus, commercial financial providers have begun to offer certain services to this market and some banks have opened full-service micro-finance operations. Not surprisingly, many NGO MFIs, lacking adequate resources, often resort to bank loans, and many have borrowed to an extent that threatens their viability. To repeat, micro-finance and micro-credit institutions must be seen as complementary to, but separate from, formal financial institutions and not embryonic forms of formal financial institutions.

But MFIs can learn from formal institutions and adopt certain kinds of professional practices. For example, many MFIs are not sufficiently equipped to undertake proper risk-assessment, and need to be trained to do so. Often, reporting systems are also not adequate, which is a problem because of the lack of accountability of many micro-finance groups. State support for improving management and accounting practices must therefore be provided.

The problems afflicting micro-finance institutions notwithstanding, the evidence does suggest that the poor can be served successfully with appropriate organizational and managerial innovations, despite the higher cost of small-scale transactions. There is also evidence that the use of information and communications technology can bring down the costs of many of the transactions and the cost differential involved in serving poor customers (United Nations, 2006). Moreover, while many micro-finance providers are, or have been, subsidized in one form or another, there are a number which operate independent of subsidy and are self-sustaining.

Nevertheless, while efforts to improve the system of micro-credit as a second channel must continue, there is no alternative to strengthening the formal credit system to deal with the challenges faced in predominantly rural developing economies with a high incidence of poverty. The aim of financial intervention is not to prevent the creation of a modern financial sector. Rather, its primary aim is to expand the reach of the formal financial sector, so as to enable the state to use the financial structure as an instrument of development. It is for this reason that development practitioners increasingly call for a paradigm shift involving a change from an emphasis on micro-finance to one on inclusive finance (United Nations, 2006).

Table 3 summarises some of the main financial policy options that can be used to realize a process of more broad-based and equitable growth.

Learning from historical experience

Policies to ensure the flow of financial savings to key sectors from a development point of view did not originate in developing countries. Financial structures in late-industrializing countries like Germany and Japan emerged or were fashioned to deal with the difficulties associated with late industrialization. Capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level. Competition from established international producers meant that firms had to be supported with protection and finance to survive long periods of low capacity utilization during which they could seek a foothold in domestic and world markets and become competitive producers. Not surprisingly, late industrializers created strongly regulated and even predominantly state-controlled financial markets aimed at mobilizing savings and using the intermediary function to influence the size and structure of investment. Despite their differences, the *hausbank* system in Germany, the lead bank system in Japan and the financial system in the Republic of Korea, epitomized this feature. Their financial systems were characterized by directed credit policies and differential interest rates, and the provision of investment support for the nascent industrial class in the form of equity, credit and low interest rates.

Based on the roles played by Crédit Mobilier in France and the 'universal banks' in Germany, Gerschenkron (1962:13) argued that the creation of "financial organisations designed to build thousands of miles of railroads, drill mines, erect factories, pierce canals, construct ports and modernise cities" was hugely transformative. Financial firms based on the old wealth were typically rentier in nature and limited themselves to floatations of government loans and foreign exchange transactions. The new financial firms were "devoted to railroadisation and industrialisation of the country" and, in the process, influenced the behaviour of old wealth as well.

Table 3
Some Salient Financial Policy Options to Promote Equity

Policy	Objective	Dangers	Requirements
Set bank branching targets, especially for underserved areas	Provide wide access to banking facilities as part of a strategy of inclusive finance		a. Possibility of cross-subsidization b. Provision of state financial support
Guidelines to prevent excessive credit migration from less to more developed areas in the country	Ensure credit created based on deposits from backward or rural areas is not all diverted to developed or urban regions	Allocation to unviable projects for lack of demand from creditworthy borrower	a. Possibility of cross-subsidization b. Provision of state financial support
"Credit authorization scheme" to monitor grant of credit limits above a particular level to any single party	Prevent concentration of credit in few borrowers		Identify an appropriate regulatory agency
Limits on credit to interlinked firms controlled by a single authority	Prevent concentration of credit in few borrowers		
Pre-emption of bank credit for selected sectors like agriculture and small scale industry: a. Specify that certain proportion of lending be directed at these sectors; b. Provide credit at interest rates lower than market rates.	a. Ensure access to hitherto neglected sectors; b. Keep cost of credit at levels where demand is forthcoming, given potential returns in these sectors	Adverse effects on bank profitability	a. Adoption of alternative performance criteria b. Possibility of cross-subsidization c. Provision of state financial support
Provide representation for all stakeholders in bank boards	a. Ensure access to hitherto neglected sectors; b. Ensure transparency and participative governance		

Table 3 (cont.)
Some Salient Financial Policy Options to Promote Equity

Policy	Objective	Dangers	Requirements
Financial institutions to play supply-leading role: a. identifying potential entrepreneurs with bankable projects; b. helping them through phases of project preparation and credit appraisal; c. ensuring successful and timely implementation; and d. use leverage from credit provision, to monitor functioning	Deal with some of the demand-side problems resulting in poor credit off-take	Credit allocation based on corruption and favouritism	Implementation of transparent procedures and participatory governance mechanisms
Provide for or strengthen public ownership of banks/development banks	a. Overcome obstacles to "social banking"; b. Increase compatibility of objectives of regulators and bankers so as to strengthen regulation	Credit allocation based on corruption and favouritism	Implementation of transparent procedures and participatory governance mechanisms
Create separate "policy banks" as opposed to general purpose development banks	a. Ensure clarity of objectives; b. Prevent misuse of policy banking requirement to justify poor performance; c. Monitor and ensure proper utilization of government support or subsidies		

Table 3 (cont.)
Some Salient Financial Policy Options to Promote Equity

Policy	Objective	Dangers	Requirements
Encourage creation of and rejuvenate pre-existing cooperative banks	a. Ensure mobilization of local savings; b. Ensure participation in the allocation of credit; c. Develop a channel suitable for directing credit and financial support to smaller borrowers	Cooperatives can become instruments for local vested interests and vehicles for political patronage	Bring cooperative banks within the ambit of a special regulatory framework which monitors management and performance
Launch and/or encourage the micro-finance movement	a. Reach the really poor; b. Ensure social mobilization; c. Develop a channel to reach extension services needed for micro-enterprises	a. High transaction costs and interest rates that limit lending for productive purposes b. Financial non-sustainability c. Donor dependence d. Poor governance	a. Treat micro-finance as a case of small scale development banking; b. Provide subsidies to support lower interest rates in lending for productive purposes; c. Use information technology to reduce transaction costs; d. Bring MFIs within ambit of the same special regulatory framework which monitors management and performance in cooperative banks.

The function played by these institutions is noteworthy. The banks, according to Gerschenkron, substituted for the absence of a number of elements crucial to industrialization: “In Germany, the various incompetencies of the individual entrepreneurs were offset by the device of splitting the entrepreneurial function: the German investment banks – a powerful invention, comparable in economic effect to that of the steam engine – were in their capital-supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major – and sometimes even not so major – decisions of the individual enterprises. It was they who often mapped out a firm’s paths of growth, conceived far-sighted plans, decided on major technological and locational innovations, and arranged for mergers and capital increases” (Gerschenkron, 1968:137).

From a development point of view, this experience implies that financial institutions must not only serve to direct credit at pre-specified interest rates, but must adopt a pro-active role in the decision making of the entities they finance. To do so, they need to mobilize the best talent – technological expertise, managerial competence and marketing skill – to facilitate the conversion of savings channelled to farms, firms and individuals into investment in productive and socially high-yielding assets.

When serving this role, financial intermediaries move up the scale from being a mere pool of savings, as they are conventionally seen, to being a pool of knowledge and expertise, allowing them to overcome the coordination failures that afflict atomistic decision-makers in market-based systems.

VI. AUTONOMY AND REGULATION

Pre-empting financial fragility

Besides pursuing the objectives of growth and equity, financial policies should be geared to ensuring the stability and sustainability of the financial system. Failures in financial markets affect not only the institution concerned, but other sectors of the economy. In some instances, this could have systemic effects. Thus, when speculative bubbles lead to financial crises, they squeeze liquidity and result in distress sales of assets and deflation with adverse impact on employment and living standards. To prevent such effects, governments often resort to costly bailouts, which too have implications for growth and equity.

Failure can never be abolished, but regulation can help to reduce the recurrence of crisis. The best model of regulation remains the framework adopted in the United States, in response to the wave of bank failures during 1920-32. Its anchor was the Banking Act of 1933 (the Glass-Steagall Act), which imposed a strong regulatory framework that developed to have five dimensions:

- First, it created the Federal Deposit Insurance Corporation (FDIC) for federal insurance of deposits. From the point of view of the small depositor, all banks became identical and completely secure, regardless of their balance sheets.
- Second, it set limitations on interest payments on deposits. Interest was prohibited for demand deposits and ceilings introduced for time and savings deposits. With these controls, the principal financial intermediaries could not attract depositors with higher interest rates, so that there was no direct

imperative to invest in assets offering high returns that are also risky and prone to default.

- Third, together with the McFadden-Pepper Act of 1927, Glass-Steagall provided for entry barriers that limited 'excessive' competition resulting from the previous regime of free banking. It reinforced the individual states' authority to restrict inter-state banking and limit bank holding companies and other instruments of concentration.
- Fourth, it restricted the operations of banks. There were restrictions on investments that banks could make, principally limiting them to loan provision and to purchases of government securities. There were prohibitions on the activities of banks or their affiliates, with a ban on underwriting securities and serving as an insurance underwriter or agency, and commercial activities. The restrictions also included a 10 per cent limit on outstanding exposure to a single borrower and limits on lending to sensitive sectors like real estate.[5] This was clearly aimed at ensuring that the moral hazard associated with deposit insurance did not lead to risky investments and at pre-empting the practice of financing losses elsewhere in the financial sector with bank equity.
- Finally, a system of regulating solvency was put in place, involving periodic examination of bank financial records and informal guidelines relating to the ratio of shareholder capital to total assets

This model served the United States extremely well for over three decades. Macroeconomic developments in the 1970s and after launched a period of accelerated "financial innovation", requiring its revision, but it remains substantially relevant for developing countries. Governments must seek to remain as close to this model as possible.

Insofar as circumstances warrant a deviation, there must be special provisions to deal with the risks involved. These should include:

- restrictions on banks lending to firms or investing in securities in which the owners/directors of the bank have an interest;
- restrictions on the volume of lending to and proportionate exposure to sensitive sectors like the stock and real estate market, and
- monitoring and reduction of high spreads between deposit rates and lending/investment returns, which provide evidence of limited competition or excessively risky investments.

Such provisions can moderate the tendency to undertake unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses if any can be transferred to the lender through default, and

[5] Real estate loans secured by first liens could not exceed total savings deposits of a bank or, if greater, its unimpaired paid-up capital and surplus.

lenders are confident of government support in case of crisis. This could feed a speculative spiral that can, in time lead to a collapse of the bubble and bank failures.

These kinds of tendencies need to be curbed also because they affect real investment. As the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than for stocks and real estate, and despite the contribution such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

Financial sector supervision and regulation

In addition to such measures, governments must implement strict regulations with regard to accounting standards, disclosure norms and governance structures. They should also put in place institutions responsible for prudential regulation of markets, involving a mix of monitoring of individual transactions, ensuring adoption of appropriate risk-management systems, routine scrutiny of company accounts, enforcement of guidelines to prevent conflict of interest and assessment of company adherence to capital adequacy norms. It must be noted that these forms of regulation do not fully insure against fragility. Advocates of freer and more open financial markets claim that capital adequacy norms and prudential regulation can deal with these problems. However, instances of increased and periodic financial failure suggest otherwise, as does the growing evidence of conflicts of interest, accounting fraud and market manipulation even in the well developed and ostensibly transparent and well regulated United States market.

Market-based financial systems are fragile and prone to failure, and regulation cannot fully redress this. Systems of social regulation and control have the advantage that regulation is built into the very structure that serves to promote development. But even then, since government-appointed agents are responsible for supervision, monitoring and scrutiny, the perennial question as to who will monitor the monitor remains. Particular agents may misuse their position, indulge in favouritism and/or corruption, and government regulation may fail. The ways of dealing with this problem is not merely to return to the market with all its deficiencies, but to evolve institutional mechanisms to monitor agents in the public sector. Central elements of such mechanisms must be participatory governance and accountability to democratically constituted bodies.

VII. ON LIBERALIZING FINANCIAL SYSTEMS

The policy conclusions emerging from the above discussion are not just relevant from the point of view of pro-actively framing financial policies, but should also serve to correct or stall policies that militate against the objectives of growth, equity and financial stability.

In recent years, however, processes of financial liberalization in developing countries have challenged many of the features of financial systems that are favourable from a developmental point of view. These processes are justified on the grounds that the interventionist financial policies adopted by developing countries to accelerate growth, improve distribution and avoid fragility, have resulted in "financial repression", involving low and even negative interest rates and distortions that divert financial flows away from the best, high-return projects (McKinnon, 1973; Shaw, 1973).

There are a number of ways in which interventionist policies are seen to have adversely affected growth (Fry, 1997). To start with, low interest rates resulting from regulation are seen to affect adversely the level of savings, and therefore investment, by encouraging current consumption. Second, low interest rates offered by financial intermediaries are seen as encouraging direct investments by savers rather than through intermediaries. Given the scale economies associated with the pooling of resources and the greater ability of financial intermediaries to identify the best projects and monitor the functioning of borrowers, this process is seen to reduce the efficiency of investment allocation. Third, since interest rates are low, the number of projects looking for funding tends to be large, resulting in the possibility that some or many low-quality projects are funded at the expense of better projects. To boot, on average, projects tend to be more capital intensive because of the lower costs of capital, with adverse employment effects. That is, low interest rates could result in inferior investment choices. Finally, since returns to lenders are low and often fixed, their lending practices are not driven by potential yields of projects financed, but influenced by extraneous factors such as political pressures, loan size or private benefits to bankers.

The adverse effects of these factors on growth, it is argued, are made worse as "repressive" financial policies limit the extent of financial deepening and intermediation. This is seen as inimical to development, based on the view that there is a strong positive relationship between financial deepening/intermediation and growth (Levine, 1997).

Box 10
Financial Strategies
Can Lead to Credit Rationing

In India, following financial sector reforms, the credit-deposit ratio of commercial banks declined substantially from 65.2 per cent in 1990-91 to 49.9 per cent in 2003-4, despite a substantial increase in the credit-creating capacity of banks through periodic reductions in reserve ratios. This may have been the result of a decline in demand for credit from creditworthy borrowers. However, one fact appears to question this argument: the decrease in the credit-deposit ratio has been accompanied by a corresponding increase in the proportion of risk-free government securities in the banks' major earning assets i.e. loans and advances, and investments. The investment in government securities as a percentage of total earning assets for the commercial banking system as a whole was 26.1 per cent in 1990-91. But it increased to 32.4 per cent in 2003-04. This points to the fact that lending to the commercial sector may have been displaced by investments in government securities offering relatively high, near risk-free returns (Chandrasekhar and Ray, 2005).

A logical corollary of the financial repression argument is that interest rates should be freed, financial markets and institutions liberalized and markets allowed to determine the allocation of credit. As has been pointed out by a number of economists (Stiglitz and Weiss, 1981; Arestis, 2005), the conceptual bases of these arguments are questionable. In particular, they are based on the assumption that liberalization delivers "competitive" financial markets, in which financial institutions compete to attract savings and identify the best borrowers. However, competitive markets do not always deliver the desired results. This is because what matters is not the number of firms that accept deposits but their willingness to offer credit, and this may be limited for other reasons even when there are a large number of banks in a country (Box 10).

In practice, liberalization delivers unanticipated results. As early as 1985, Diaz-Alejandro (1986) detailed why efforts in Latin America in the 1970s to follow the recommendations of the financial repression literature and "free domestic capital markets from usury laws and other alleged government-induced distortions" had "yielded by 1983 domestic financial sectors characterized by widespread bankruptcies, massive government interventions or nationalization of private institutions (to save financial firms and pre-empt adverse effects), and low domestic savings."

Rather than encouraging greater competition, there was a strengthening of oligopolistic power through the mergers of financial intermediaries or association of financial intermediaries and non-financial corporations. Financial intermediaries that were a part of these conglomerates allocated credit in favour of companies belonging to the group, which was by no means a more efficient allocation than could have occurred under directed-credit policies of the government.[6]

Further, financial liberalization did not result in intermediation of financial assets with long-term maturities, with deposits and loans of less than six months' duration dominating. The Southern Cone experience of the late 1970s and early 1980s suggest that deregulation did not lead to stable interest rates, that interest rates on the whole could remain very high and way above "reasonable estimates of the socially optimal shadow real interest rate."

[6] In India, nationalisation of the bigger private commercial banks in 1969 was partly motivated by the need to prevent the diversion of household savings to companies linked to the banks or their directors.

Finally, despite short booms in stock markets, there was little mobilization of new capital or capital for new ventures. In fact, small investors tended to withdraw from markets because of allegations of manipulation and fraud, and erstwhile areas of long-term investments supported by state intervention tended to disappear. While financial liberalization did encourage new kinds of financial savings, total domestic savings did not increase in many cases, and expansion of available financial savings was the result of inflow of foreign capital.

Despite the repetition of this experience across the developing world since the early 1970s, many developing countries have opted for similar policies, either necessitated by conditionalities imposed by donors when countries turn to them for emergency balance of payments finance, or voluntarily in the hope of attracting large capital flows into their economies. That is, there is a strong correspondence between unavoidable or voluntary dependence on capital flows and processes of financial liberalization.

These processes militate against the adoption of financial policies appropriate for development and even dismantle financial structures that are suitable from a development point of view, as discussed above. There are three broad effects from the process of financial liberalization:

- it opens the country to new forms and larger volumes of international financial flows, in order to attract part of the substantially increased flows of financial capital to the so-called "emerging markets" since the late-1970s;
- to facilitate these inflows, it liberalizes, to differing degrees, the terms governing outflows of foreign exchange in the form of current account investment income payments and capital account transfers for permitted transactions, and
- to attract these flows, it transforms the structure of the domestic financial sector and the nature and operations of domestic financial firms such that it makes the financial system resemble that adopted over the last three decades at much higher levels of development in countries like the United States and the United Kingdom

It is now widely accepted that the first two of these, involving liberalization of controls on inflows and outflows of capital respectively, have resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. Analyses of individual instances of crises have tended to conclude that the nature and timing of these crises had much to do with the shift to a more liberal and open financial regime. What is more, crises rarely lead to controls on capital inflows and reduced dependence on them. Rather, adjustment strategies emphasize further financial liberalization, resulting in a history of periodic financial failure.

But what requires special attention are the structural effects (elaborated in Box 11) of liberalization on the ability of countries to use the financial system as an instrument in a national development strategy. As might be expected from the above discussion, the empirical experience with financial liberalization is that it results in:

- declining credit-deposit ratios or reduced credit provision;
- "diversion" of credit to sensitive sectors, such as the stock market and real estate, as well as to consumer finance;

- greater emphasis on "investments" in instruments such as government securities or certificates of deposit issued by corporations;
- a preference for commissions and fee-based incomes rather than returns from interest rate spreads;
- an unwillingness of banks to perform their role as the principal risk bearers in the system, with a market preference to use innovative instruments to transfer credit risk to institutions and investors less equipped to assess such risks, and
- a greater degree of financial exclusion, with a growing concentration of credit and investment in a few favoured sectors and its direction to larger clients.

A set of country studies in Sub-Saharan Africa by Cornia and Lipumbia (1999) for UNU/WIDER found that a decade or more of financial liberalization notwithstanding, the removal of financial repression had not increased the volume of credit available to the small-scale urban sector and to rural areas. This has occurred, despite the fact that the number of private banks had grown, and the share of credit allocated to the private sector had increased while that of the public sector had decreased. What is more, real lending rates had risen sharply while deposit rates had declined and spreads had soared markedly. As a result, savings and investment rates had not increased. The increase in the number of banks had not markedly reduced the concentration of bank deposits and assets. Most of the loans continued to be of short-term maturity, financing mainly trade. Long-term finance for agricultural and industrial development was not available. The majority of the population working in smallholder farms and small- and medium-scale enterprises had no access to credit. And, with limited supervision from understaffed central banks and weak regulatory frameworks, the rapid creation of new financial institutions had been accompanied by greater instability and a rise in the number of bank failures. The results of the policies seem to be the same when applied to both small and large as well as less and more developed among developing countries.

Box 11

The Structural Consequences of Financial Liberalization

There are a number of aspects and consequences of financial liberalization as implemented in practice. To start with, it involves reducing or removing controls on interest rates or rates of return charged or earned by financial agents. This encourages competition between similarly placed financial firms to attract depositors on the one hand, and entice potential borrowers on the other. Competition not only takes non-price forms, but leads to price competition that squeezes spreads and forces firms to depend on volume to profit. This often leads to diversification of activity away from socially relevant, but privately less profitable areas.

The second feature of financial liberalization is that it removes or dilutes controls on the entry of new financial firms, subject to their meeting pre-specified norms with regard to capital investments. This aspect of liberalization inevitably applies to both domestic and foreign financial firms, and caps on equity that can be held by foreign investors in domestic financial firms are gradually raised or done away with. Easier conditions of entry do not automatically increase competition in the conventional sense, since liberalization also involves freedom for domestic and foreign players to acquire financial firms and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets. This often triggers a process of consolidation that creates or restores a nexus between large oligopolistic players and financial intermediaries with attendant implications.

Thirdly, liberalization involves a reduction in controls over investments that can be undertaken by financial agents. Financial agents can be permitted to invest in areas they were not permitted to enter previously. Most regulated financial systems seek to keep separate the different segments of the financial sector such as banking, merchant banking, mutual funds and insurance. Agents in one segment were not permitted to invest in another for fear that conflicts of interest could affect business practices adversely. Financial liberalization breaks down the regulatory walls separating these sectors, leading, in the final analysis, to the emergence of so-called "universal banks", or financial supermarkets. The consequent ability of financial agents to straddle multiple financial activities implies that the linkages between different financial markets tend to increase, with developments in any one market affecting others to a far greater degree than previously. Besides increasing the probability of failure, this influences lending and investment practices in ways unsuited to broad-based national development.

Fourth, liberalization involves relaxation of the rules governing the kinds of financial instruments that can be issued and acquired. Financial instruments allow agents to share financial gains and risks to differing degrees, where the gains are incomes and asset price appreciation and the risks are default on interest payments and amortization, interest rate changes or depreciation of asset values. These assets can be issued directly by those looking for capital for productive investments, or by intermediaries expecting to obtain part of the incomes in return for bearing part of the risk. This aggravates the tendencies noted above.

Fifth, in many contexts, liberalization involves withdrawal of the state from financial intermediation, with the conversion of "development banks" into regular banks and privatization of the publicly owned banking system, on the grounds that their presence is not conducive to the dominance of market signals in the allocation of capital.

Sixth, financial liberalization eases conditions for the participation of both firms and investors in the stock market by diluting or removing listing conditions, by providing freedom in the pricing of new issues, by permitting greater freedom to intermediaries such as brokers, and by relaxing conditions on borrowing against shares and investing borrowed funds in the market.

Finally, rather than regulation through direct intervention, liberalization involves shifting to a regime of voluntary adherence to statutory guidelines with regard to capital adequacy, accounting norms and related practices, with the central bank's role being that of supervision and monitoring.

Since market forces mediate the realisation of these outcomes, financial liberalisation policies, often adopted on the grounds that the financial proliferation resulting from such liberalisation is an unqualified good, can result in an aggravation of the problem of financial exclusion (Box 12).

Box 12

Financial Liberalisation and Financial Exclusion

The experience of a small, land-locked Least Developed Country like Nepal illustrates how financial liberalisation can result in financial exclusion. After the liberalisation of Nepal's financial system, the evidence (Deraniyagala et al., 2003) points to an eight-fold increase in deposit mobilisation by the banking sector during the 1990s (from Rs 22 billion in 1990 to Rs 181 billion in July 2001).[7] Deposit mobilisation by finance companies also increased substantially. As a ratio to GDP, bank deposits increased from 19 per cent in 1985 to 43 per cent in 2001. Deposits with non-bank financial institutions also increased from 0.5 per cent of GDP in 1995 to 4.6 per cent in 2001. The consequent increase in financial intermediation is reflected in the fact that the ratio of financial assets to GDP rose from 29.3 per cent in 1985 to 32.5 per cent in 1990 and a huge 84.3 per cent in 2001. Financial deepening and increased financial intermediation obviously increased credit provided by the financial system substantially. Commercial banks' credit to the private sector rose from 8.7 percent of GDP in 1985 to 29.4 percent in 2001.

This process was not accompanied by adequate provision of credit to the poverty-sensitive sectors. Of the credit provided by commercial banks in 2001, only 9 per cent went to the agricultural sector, although 80 per cent of the country's population was involved in cultivating some land and 50 per cent derived their incomes from agriculture, making it extremely important in terms of livelihoods and poverty reduction. On the other hand, credit to industry increased from 18.8 per cent in 1985 to 45 per cent in 2001. Part of this increase reflected a shift from the commercial sector, whose share fell from 44 to 33 per cent over the same years, but a shift away from agriculture was also responsible. Further, small borrowers must have suffered discrimination as 85 per cent of formal sector lending is based on collateral. The evidence indicates that despite financial consolidation, not more than a fifth of borrowing households in Nepal are covered by institutional finance.

This trend is not surprising as liberalization has seen the rise to dominance of the private financial sector. The ratio of private sector credit to total credit rose from 68.5 per cent in 1985 to 76.2 per cent in 1990 and to an overwhelming 92.5 per cent in 2001.

As Mkandawire (1999) notes, Ffrench-Davis' argument for Latin America has resonance in the African case when he argues that "what is needed is an institutional framework that encompasses a vigorous long-term segment of the financial market, in order to finance productive investment. In addition, low- and medium-income sectors, which typically suffer from the social segmentation of the capital market, need easier access to capital. They need this market to deal with contingencies, to invest in training and to promote the development and modernization of productive activities" (Ffrench-Davis, 1994:239).

Finally, greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients, and increased regulatory forbearance, all lead to increased instances of financial failure. In addition, by institutionally linking different segments of financial markets

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[7] Some caution must be exercised when interpreting these figures. There is reason to believe that a substantial part of what was occurring was a transfer of savings and credit provision from the informal to the formal credit system.

by permitting the emergence of universal banks or financial supermarkets, the liberalization process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure of entities in any one segment of the financial system on agents elsewhere in the system.

The implication for governments is clear. If the intention is to put in place financial policies that promote growth, privilege stability and ensure inclusion, an emphasis on financial liberalization as a panacea for problems in the functioning and impact of the financial sector should be abjured.

VIII. FOREIGN SAVINGS AND THEIR IMPLICATIONS

Financial liberalization is often driven by the desire of developing country governments to attract large volumes of foreign capital inflows, especially purely financial flows. It is often argued that access to foreign savings in the form of capital flows reduces the pressure on developing country governments to extract and allocate domestic savings, reducing the need for intervention that may go awry. Access to foreign finance – in the form of grants, debt and foreign portfolio and direct investment – relaxes the constraints domestically available real resources set on the potential rate of growth of the system. Foreign exchange, being a "fungible" asset, can be used to alter the structure of domestic supply through imports. Depending on how foreign exchange resources are deployed, they can overcome domestic supply constraints, such as a wage-goods, or a capital goods, constraint, by resorting to imports. On the financial side, these resources reduce the need to use measures such as taxation to restrain the consumption of particular commodities by particular groups, in order to mobilize surpluses needed to finance long-term development. Further, inasmuch as foreign "savings", in the form of foreign aid or foreign borrowing are accessed directly by the state they can be allocated in line with the preferences of the state and in keeping with its strategy of development.

However, for most developing countries, the volume, pattern and direction of foreign capital flows cannot be chosen, but are exogenously given by the political choices of donor governments, the lending strategies of multilateral agencies, the preferences of private creditors and investors and the state of play in international financial markets. While some of the more developed among developing countries can attract flows of the kind they want some of the time, that flexibility is predicated on creating a facilitating environment for autonomous capital flows which often reduces policy space and involves a loss of control.

Foreign finance is not costless. While grants can be considered as pure transfers, their volume is small and their share has been declining over time. Other forms of capital flows have the following costs and implications:

- First, as with domestic debt, foreign debt carries a pre-specified profile of interest payment commitments. If the deployment of these resources does not result in a rate of nominal output growth greater than the nominal rate of interest, resources must be diverted from elsewhere to meet these costs, or further debt has to be contracted to meet payment commitments.
- Second, these commitments must be met in foreign exchange, necessitating the transformation of domestic resources into foreign exchange. To the extent that there are specific constraints on the possibilities of transformation through trade, reliance on foreign savings can increase external vulnerability.

- Third, access to foreign finance very often comes with conditionalities that limit the policy space of the government – that is, relying on foreign finance to finance a development strategy may reduce the strategic options available to a government, including options relating to financial policy. Official flows are conditional upon the pursuit of specified monetary, fiscal or other policies. Private flows are implicitly conditional upon minimizing government intervention and the pursuit of market-friendly policies.
- Fourth, accessing foreign finance through the foreign direct investment route may involve a net foreign exchange outflow in the medium or long term, since cumulative flows in the form of repatriated dividends, royalty payments and technical fees tend to far exceed the actual inflow of foreign equity and reinvested profit share of foreign investors and the foreign exchange earned by net exports of the concerned firm.
- Fifth, reliance on debt and portfolio flows from private commercial banks and investors may require changing financial sector policies and embracing financial openness in a way that reduces the ability of the government to use the financial structure as an instrument in a national development strategy.
- Finally, reliance on private flows may increase dependence on capital inflows that are more volatile, resulting in an increase in external vulnerability and increasing the threat of a currency/financial crisis.

Given these factors, governments cannot assume that their access to foreign savings will remain at peak levels attained in the past or will grow at rates recorded in the past. A substantial degree of volatility must be provided for. This implies that excessive dependence on foreign savings to finance current expenditures or investments in sectors producing non-tradeables should be abjured. So also should the soft option of making foreign savings a substitute for domestic savings.

Capital flows and financial fragility

The fact that not all countries receive significant inflows of private capital, which tend to be concentrated in a few developing countries, is not necessarily a disadvantage. The East Asian crisis of 1997 and the large number of crises that have followed in countries such as Russia, Turkey, Brazil and Argentina, have also focused attention on other dangers associated with an excessive reliance on fluid finance. Some of these dangers are:

- First, notwithstanding all talk of efficiency of financial markets, the structure of the financial system appears to be such that banks and financial institutions from developed countries are not merely prone to over-exposure in individual markets, but to exposure reflective of unsound financial practices. A combination of moral hazard generated by an implicit guarantee from the state that the financial system will be bailed-out in periods of crisis, the herd instinct characteristic of imperfect financial markets, and the competitive thrust for speculative gains on funds garnered from profit-hungry investors, all result in a situation where lending to, and financial investments in, particular countries continued well after evidence of high-risk exposure had exceeded warranted limits. The corollary is that supply-side factors are likely to result in high volatility in financial flows to developing countries, with a surge in such flows followed in all likelihood by a sudden collapse.

- Second, a sudden and whimsical turn-around in flows can set off currency speculation in the host country which can have extremely severe consequences for the exchange rate. Once the speculative fever begins, three factors appear to drive down the exchange rate. One, a collapse in investor confidence results in a panic withdrawal of funds invested in equity shares and bonds and also prevents the rollover of short-term debt by multinational banks. Two, a scramble for dollars on the part of domestic banks and corporations with imminent dollar commitments, the domestic currency costs of which are rising in the wake of depreciation. Three, an increase in speculative operations by domestic and international traders cashing in on currency volatility.
- Third, with completely unbridled capital flows, it may not be possible for a country to control the amount of capital inflow or outflow, and both movements can create undesirable consequences. For example, a country suddenly chosen as a preferred site for foreign financial investment can experience huge inflows which in turn causes the currency to appreciate, thus encouraging investment in non-tradeables rather than tradeables, and altering domestic relative prices and therefore incentives. Simultaneously, unless the inflows of capital are simply (and wastefully) stored up as accumulated foreign exchange reserves, they must necessarily be associated with current account deficits. In other words, once there is completely free capital flows and completely open access to external borrowing by private domestic agents, there can be no "prudent" macroeconomic policy; overall domestic balances or imbalances will change according to the behaviour of capital flows, which will themselves respond to the economic dynamics that they have set into motion.
- Fourth, when the surge in capital flows is reversed, a massive liquidity crunch and a wave of bankruptcies result in severe deflation, with attendant consequences for employment and the standard of living. Asset prices collapse, paving the way for international acquisitions of domestic firms at low prices denominated in currencies that have substantially depreciated. Such acquisitions are, however, encouraged, since they are often the only means to restructure and revive cash-strapped corporations. A crisis triggered by finance capital becomes the prelude to conquest by international capital in general, with substantial changes in the ownership structure of domestic assets without much green-field investment.
- Finally, the East Asian crisis brought home the fact that financial liberalization can generate crises in so-called ‘miracle economies’ as well.

Managing external debt and capital flows

Given these features, countries formulating a national development strategy need to:

i. make a realistic assessment of potentially available foreign savings and their likely composition and direction;

ii. assess the domestic and foreign exchange costs of relying on these inflows;

iii. choose an appropriate volume and composition of such inflows;

iv. design policies to restrict flows to that magnitude and structure, and

v. ensure that foreign capital inflows are not a substitute for domestic savings, but an additional contribution to investment.

These choices establish the external frame in which an appropriate domestic financial policy is pursued.

Managing inflows requires capital controls, or measures that manage the volume, composition, or allocation of international private capital flows. They can target either inflows or outflows and can be market-based (incentive-based) or involve strict quantitative limits. Special reserve requirements for capital flowing in are an example of a market-based control. On the other hand, quantitative capital controls involve outright bans or quotas on certain investments such as the purchase of equity by foreign investors.

However, as Epstein et al. (2003) argue, it can be difficult to draw a clear line between prudential domestic financial regulation and capital controls. For example, domestic financial regulations that limit the maturity range or specify reporting requirements for inflows may influence the composition of international capital flows to a country. Thus, prudential domestic financial regulations are another type of capital management technique.

Based on an examination of the diverse capital management techniques (Table 4) employed by countries during the 1990s Epstein et al. (2003) argue that:

- Capital management techniques can enhance overall financial and currency stability, buttress the autonomy of macro and micro-economic policy, and bias investment towards the long-term.
- The macroeconomic benefits of capital management techniques outweigh the often scant evidence of their microeconomic costs.
- Capital management techniques work best when they are coherent and consistent with a national development vision.
- There is no single type of capital management technique that works best for all developing countries.

Table 4
Types and Objectives of Capital Management Techniques Employed During the 1990's

Country	Types of Capital Management Techniques	Objectives of Capital Management Techniques
Chile	**Inflows** *FDI and PI: 1-year residence requirement *30% URR *Tax on foreign loans: 1.2% per year **Outflows**: No significant restrictions **Domestic Financial Regulations**: strong regulatory measures	– Lengthen maturity structures and stabilize inflows – Help manage exchange rates to maintain export competitiveness – Protect economy from financial instability
Colombia	**Similar to Chile**	Similar to Chile

Country	Types of Capital Management Techniques	Objectives of Capital Management Techniques
Taiwan POC	**Inflows** *(a) Non-residents* *bank accounts only for domestic spending, not financial speculation *foreign participation in stock market regulated *FDI tightly regulated *(b) Residents* *regulation on foreign borrowing **Outflows** *exchange controls **Domestic Financial Regulations** *restrictions on lending for real estate and other speculative purposes	– Promote industrialization – Help manage exchange for export competitiveness – Maintain financial stability and insulate from foreign financial crises
Singapore	**"Non-internationalization" of Singapore $ inflows** **Outflows** *Non-residents* *financial institutions can't extend S$ credit to non-residents if they are likely to use for speculation *if they borrow for use abroad, must first swap into foreign currency **Domestic Financial Regulations** *restrictions on creation of swaps, and other derivatives that can be used for speculation against S$	– to prevent speculation against Singapore $ – to support "soft peg" of S$ – to help maintain export competitiveness – to help insulate Singapore from foreign financial crises
Malaysia (1998)	**Inflows** *restrictions on foreign borrowing **Outflows** *(a) Non-residents* *12 month repatriation waiting period *graduated exit levy inversely proportional to length of stay *(b) Residents* *exchange controls **Domestic Financial Regulations** *(a) Non-residents* *restrict access to ringgit *(b) Residents* *encourage to borrow domestically and invest	– to maintain political and economic sovereignty – kill the offshore ringgit market – shut down offshore share market – to help reflate the economy – to help create financial stability and insulate the economy from contagion

Country	Types of Capital Management Techniques	Objectives of Capital Management Techniques
India	**Inflows** *Non-residents* *strict regulation of FDI and PI **Outflows** *(a) Non-residents* *none *(b) Residents* *exchange controls **Domestic Financial Regulations** *strict limitations on development of domestic financial markets	– support industrial policy – pursue capital account liberalization in an incremental and controlled fashion – insulate domestic economy from financial contagion – preserve domestic savings and forex reserves – help stabilize exchange rate
China	**Inflows** *Non-residents* *strict regulation on sectoral FDI investment *regulation of equity investments: segmented stock market **Outflows** *(a) Non-residents* *no restrictions on repatriation of funds *strict limitations on borrowing Chinese Renminbi for speculative purposes *(b) Residents* *exchange controls **Domestic Financial Regulations** *strict limitations on residents and non-residents	– support industrial policy – pursue capital account liberalization in incremental and controlled fashion – insulate domestic economy from financial contagion – increase political sovereignty – preserve domestic savings and foreign exchange reserves – help keep exchange rates at competitive levels

Source: Epstein *et al.* (2003)

Even when it comes to attracting foreign direct investment, countries should, at the minimum, seek to ensure that foreign exchange investment in and export revenues from these units balance the foreign exchange out-go on account of royalties, technical fees, dividends and imports. This is a long-term safeguard against external vulnerability. A maximal objective of foreign direct investment management should be that the employment created as a result of the investment does not fall short of the employment displaced by the activities of the unit concerned.

IX. CONCLUSIONS

In sum, the premises on which governments should design financial policies as part of a national development strategy are that:

- Actually existing markets cannot and do not correspond to any ideal that delivers optimal outcomes that no one wants to change;
- Far more than markets for most other goods and services, financial markets are characterized by features that deliver outcomes that can adversely affect growth and aggravate inequities in the sectoral, regional, group and individual distribution of the benefits of growth;

- The structure and behaviour of financial systems that are not socially controlled and regulated is such that they do not advance the objectives of growth and financial inclusion, and
- Financial markets left to themselves are prone to failure leading to closure of financial firms, losses for consumers and clients, and systemic fragility with adverse macroeconomic implications.

Therefore, intervention is needed to ensure:

- availability of credit to viable projects in crucial sectors at sustainable rates,
- access to financial markets for all, and
- the soundness and stability of the financial system.

A range of policy options is available to meet each of these objectives. The specific mix of policies that governments choose will and should vary with the relative importance of specific objectives in their own national context, the degree of development and diversification of the financial system, and the area of control or degree of manoeuvrability of the government concerned. However, the aim should be to move over time to a best-practice combination of financial policies that advance the objectives of growth, equity and human development.

It must be noted that the use of any set of policy instruments implies a certain presence and role for the state. This raises the issue of government failure, resulting not just from errors of judgment, but also from pursuit of individual rather than social objectives by government agents, favouritism and corruption. Thus policies must be implemented in a framework that is transparent, requires full disclosure and is subject to monitoring by bodies that are democratically constituted.

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